State Health Benefits for Retired Employees

Fiscal Brief

March 23, 2007

Recognition of Long-term Liabilities Under New Governmental Accounting Standards for Other Post-Employment Benefits

Executive Summary

The Governmental Accounting Standards Board (GASB) has adopted new standards that significantly change how public employers must measure, expense and disclose obligations for other non-pension post-employment benefits. These new standards require public employers to use actuarial valuation methods and accrual accounting conventions — similar to the way pension obligations are measured and reported — to acknowledge the accumulation of Other Post-Employment Benefit (OPEB) liabilities. The most significant OPEB for the State of North Carolina is health benefit coverage provided to retired employees of State agencies and departments, university institutions, local public school agencies, and local community college institutions.

This change is significant. The State currently uses cash basis accounting to expense the annual premium charges to fund this benefit on a pay-as-you-go basis. Pay-as-you-go funding results in the annual premium charges for benefit coverage being expensed and reported as it is paid each year during a former employee's retirement term. The new GASB standards alternatively use accrual accounting to expense in current dollars an actuarial estimate of the projected future costs for the benefit as it is earned over the employee's working career or employment term.

The State's first formal actuarial valuation of retired employee health benefit coverage reports a $23.786 billion unfunded liability as of December 31, 2005. This liability represents, in today's dollars, the unfunded benefit obligations already earned by current retirees, active employees, and inactive former employees eligible to retire at some point in the future.

To reduce this unfunded liability the State has the option to annually fund this obligation as a series of yearly amortized payments over the next 30 years. Moreover, to avoid accruing additional liability the State would also have to begin pre-funding the yearly normal cost of future benefits as they are earned by active employees over their working careers. The funding of these costs creates an asset that along with investment returns is available to fund future benefit costs as they come due. If the State chooses not to pre-fund these future costs, then the expense accrues as an unfunded liability.

The sum of these normal and unfunded liability costs would require annual outlays for retired employee health benefit coverage to increase from the current pay-as-you-go amount of $476.8 million per year to nearly $1.7 billion per year on an actuarial and accrual accounting basis (as of December 31, 2005). If these projected expenses are fully funded, there may be an immediate negative impact to the State's other budget priorities. If not funded, then the current unfunded liability will continue to grow possibly adversely affecting bond rating agencies' views of the State's creditworthiness over time.

The purpose of this brief is to inform the NC General Assembly about GASB's new standards and to discuss relevant issues regarding the potential impact to the State, if any, these new requirements may hold.